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TAGS: ECON ETRD EAGR EAID CE ECONOMICS
SUBJECT: GSL ECONOMIC PLAN HEAVY ON PROMISES, SHORT ON DETAILS

Classified By: ECONCHIEF DEAN THOMPSON, REASONS 1.5 D AND E.

¶1. (C) Summary: Following the Central Bank's first quarter review of the Sri Lankan economy, which indicated strong GDP growth and posited a generally sound economic situation, the UPFA Government released its "Economic Policy Framework." The plan clearly notes the GSL,s focus on the agricultural and Small and Medium Enterprise sectors, but, as one observer put it, "does not answer how they intend to get where they want to go." It also appears to strongly favor government intervention, and promises of heretofore illusory public sector efficiency, rather than market forces and export-led growth to lift the nation's economy. In the run-up to the policy framework's release, there have also been conflicting statements from GSL officials on issues such as privatization. It is possible that much of this stemmed from internal debate and that the release of the framework may help keep elements of the GSL "on message." The stated link of the policy framework to the UPFA's election manifesto, its continual criticism of the former Government's economic plan and the avoidance of straightforward policy recommendations lend credence to the notion that this policy framework is largely a political beast, leaving most of the heavy lifting to the implementation phase. End Summary.

Central Bank Lauds Continued Economic Growth

¶2. (U) The Central Bank,s first quarter (a period under the economic stewardship of the previous UNP Government) report on the Sri Lankan economy, issued on June 29, indicated that GDP grew at an annualized rate of 6.2 percent, marking the seventh consecutive quarter that Sri Lanka recorded economic growth in excess of 5.5 percent. The Central Bank credited this performance to a generally sound macroeconomic environment and a continuation of the ceasefire between the GSL and the Liberation Tigers of Tamil Eelam (LTTE) terrorist organization.

¶3. (U) Not all economic sectors shared in the expansion, however. While the services sector continued its strong growth rate at 9.5 percent (providing 80 percent of the GDP growth) and the industrial sector grew by 5.5 percent, the agricultural sector contracted by 1.4 percent (a result of dry weather conditions affecting domestic agriculture and tea output) widely felt to have been the harbinger of bad electoral tidings for the previous government.

¶4. (U) While the Bank was generally positive about the direction of the economy, it warned that continued success relied on increased investment, which would only continue as a result of increased political stability, a long-term solution to the civil conflict with the LTTE, further improvements in macroeconomic management, implementing much needed structural reforms and more effective aid utilization, particularly in support of infrastructure (power and roads).

UPFA Plan: Protecting our Sectors, Buying Your Votes

¶5. (SBU) On the heels of this largely positive economic news, the GSL issued its "Economic Policy Framework" (EPF) "Creating our Future, Building our Nation." The EPF is general and heavily focused on Small and Medium Enterprises (SME) and agriculture, the two sectors from which the UPFA Government believes it draws its electoral strength.

¶6. (C) While more specific aspects of the EPF are outlined below, a principle criticism has been that it is short on specifics. IMF ResRep Jeremy Carter ((please protect)) told Econchief that the plan is more akin to an election speech, noting that it adhers closely to the UPFA's election manifesto. His primary concern was the lack of financial figures associated with the plan's goals. Carter suggested that the GSL,s mid-year fiscal review painted a bleak picture on the deficit front, driven by the GSL's abysmal revenue collection performance. In that regard, the EPF's deficit pledge (8% of GDP) was unrealistic. The deficit will be the IMF's main concern and IMF approval will be needed for World Bank budget assistance as well. During a separate meeting between Econchief and Japanese Economic Counselor

Mitsuo Kawaguchi, Kawaguchi indicated that the GOJ believes that Sri Lanka's economic fundamentals are basically sound, but the UPFA's plan "tells a nice story, but doesn't answer how they intend to get where they want to go". These sentiments have been echoed in the press by several leading business figures and organizations.

Macro-Economic Goals

¶7. (U) In its EPF, the GSL sets macroeconomic targets of 6-8 percent GDP growth, enhanced revenue collection (20 percent of GDP), and deficit reduction (8 percent of GDP in 2004, narrowing to five percent "over the medium term"). The GSL would maintain a liberal foreign exchange policy, with Central Bank interventions to smooth fluctuations. Regarding inflation, the EPF calls for a regular price surveillance mechanism to ensure competitive prices for essential food items. The mechanism would include "profit percentage caps," set by an internal rate of return (IRR) index. This IRR index would be extended to public transport and other services as well. The GSL claims priority will be given to an "island-wide infrastructure development program and social safety net."

It's the UNP's Fault

¶8. (SBU) The EPF is heavy on criticism of the previous Government, which changed in April 2004. The current UPFA Government blames the former UNP Government for increasing the deficit by increasing debt relative to GDP. The plan blames revenue shortfalls on the prior Government,s tax amnesty program and corruption. It accuses the former regime,s poverty reduction program "Regaining Sri Lanka" of gutting popular rural development programs, education initiatives and needed government support for industrial development.

New Layers to the Bureaucracy, or Old Wine in New Wineskins

¶9. (U) The EPF calls for the creation of a National Council for Economic Development (NCED) a permanent secretariat charged with improving policy formulation and implementation in a well-coordinated fashion. Line Ministries would retain their day-to-day implementation responsibilities. There will also be a Strategic Enterprise Management Agency (SEMA) charged with overseeing public enterprises, returning them to profitability and channeling those profits into Government coffers. SEMA CEO Mano Tittawella, also a Senior Policy Advisor to the President, told Econchief that SEMA's focus will be on reforming poor performers and looking for market oriented solutions to their problems, but not through privatization. The EPF also calls for a National Procurement Agency (NPA), charged with streamlining the unwieldy, non-transparent government procurement process. Treasury Secretary P.B. Jayasundera told the Ambassador on July 12

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that the NCED and SEMA would be working closely with the private sector to "add structure" to the EPF and identify those policies the GSL will need to pursue to help the EPF take root.

¶10. (SBU) The development of the North-East, a key issue for progress on the peace front, gets relatively short shrift in the plan. The GSL acknowledges that relief and rehabilitation efforts in the North East are important to all stakeholders in the peace process. The Government intends to implement relief activities primarily through the North-East Provincial Council and the District Secretariats. The Ministry of Relief, Rehabilitation and Reconciliation would be the apex coordinating body, coming directly under the President.

¶11. (U) The following are some highlights of the UPFA,s main goals outlined in the plan:

Agriculture:

The GSL,s key economic objective is to assist the agricultural sector to become self-sufficient in food production and food security. The EPF claims Sri Lanka can achieve self-sufficiency in milk, sugar, vegetables and rice, but that these segments cannot compete with imports due to misaligned trade and tariff regimes. Assistance will be provided through new technology, subsidized inputs, storage and credit facilities, as well as continued high tariffs on key agricultural commodities. Cultivation zones will be established for strategic food crops (potato, onion, other vegetables). Expert assistance will be provided to farmers in remote and war-affected areas of the country. Existing irrigation facilities will be rehabilitated and drought resistance technologies popularized. Livestock and fisheries sectors will be targeted for improvements, including infrastructure development. Duty on agricultural commodities will be maintained at the "high duty range" of 25-35 percent or "such other appropriate rates to insulate pressure

on domestic agriculture."

Small and Medium Scale Industries:

SMEs are referred to as the &nerve center of economic development" and the EPF suggests that a primary focus should be protecting this sector from undue import competition, while at the same time "balancing the needs of consumers." The GSL will promote SME entrepreneurs through the establishment of a "multi-prong support mechanism" consisting of streamlining bureaucratic procedures related to taxation, customs, and export procedures; increased training to SMEs; technical support in the areas of quality management, productivity improvement, IT access; access to venture capital equity funds and SME development finance; programs to foster the emergence and deepening of selected industrial clusters with comparative advantage; efficient and cost-competitive infrastructure development. Donor countries will also be asked to assist in SME development by providing access to best practice knowledge, upgrading the capacity of SME associations and committing resources to SME competitiveness programs.

The Public Service:

Public servants are going to become more responsible and efficient, with time-based targets and financial incentives for meeting efficiency goals. The departments of Inland Revenue, Customs and Excise will be the first agencies to undergo modernization and improvement. The 27,000 unemployed graduates the GSL pledged to hire are going to become "Change Agents" in the public sector, following a comprehensive management-training program.

Export Sector:

The GSL will promote maximum value-addition to domestic raw materials for export. The GSL will ban the export of local minerals in raw form and encourage the establishment of processing and conversion plants to upgrade the industry toward value-added finished goods. The GSL will encourage agricultural producers to move from bulk to packaged exports.

Textile and Apparel Industry:

In its opening chapter, the EPF taunts the garment sector (indirectly) for not making "distinctive claims about the local identity based on environment attributes, and socially responsible corporate and individual citizen behavior standards." The EPF indicates the GSL will provide assistance to consolidate the lead role of textile and apparel manufacturing and export in the economy, enabling it to perform efficiently in the post-2005, quota-free era. The GSL will promote global market access, particularly bilateral arrangements with the EU markets. The GSL will also offer special assistance to enhance Sri Lanka,s competitiveness, through the development of design skills, the opening of promotion offices, trade lobbying and business development in global markets. The GSL will assist the garment industry to leverage Sri Lanka as an apparel producer that is the "only socially responsible business practitioner in Asia..."

Tourism:

The GSL would like to refocus the tourism sector away from high-volume European charter groups for resort holidays, toward smaller, "higher-spending" eco-conscious tourists. The GSL refers to this as a shift from "quantity to quality." Tourism will be developed in a matter that safeguards Sri Lanka,s environment, while providing unique, Asia-oriented holiday experiences. (Note: The plan does not talk about the need to improve infrastructure to meet the needs of these up-market tourists. End note.)

Transportation:

Regional bus and rail companies will be redeveloped to become "efficient transport agencies." The GSL will increase the operational bus fleet of the regional bus companies and improve route diversity. Additional law enforcement and streamlined administration will enhance efficient operation of the transportation industry. Rail service will be modernized and passenger usage will be increased through improved service reliability. A fare structure based on an agreed IRR will be implemented.

Infrastructure:

The GSL believes the country cannot rely on the private sector to build infrastructure. The road-network will be expanded and the country,s power generation plan will be implemented as the highest national priority. Development of the Colombo South Port, the Galle Port, the airport terminal facility and an Air Cargo Village will be immediate development priorities. The GSL,s infrastructure development strategy will also include rural water supply

schemes, economic centers, storage facilities and recreation and leisure facilities.

Other areas of note:

The GSL will introduce legislation to provide an institutional mechanism to facilitate restructuring of financially troubled enterprises.

The GSL will take steps to revive the construction industry, including the development of a Construction Industry Guarantee Fund and the exploration of opportunities for local contractors in foreign-funded projects. The GSL will also encourage the sourcing and manufacture of construction industry materials based on local raw materials.

The GSL has targeted the building of 300,000 housing units island-wide.

Corporate best practices will be encouraged and regulatory frameworks will be further developed.

Regulatory surveillance of the financial sector will be strengthened.

One Government, Several Voices

¶12. (C) The lead up to the release of the Government's EPF was marked by several conflicting public pronouncements, ranging from Trade Minister Fernandopulle's recent assurances in Washington that the GSL will follow the former regime's economic reform policies, including privatization, to Treasury Secretary Jayasundera's hard-core adherence to the UPFA election manifesto insistence that no privatization will take place. In the middle is Finance Minister Amunugama, who has flip-flopped on the issue, but lately has been indicating that if loss making state-owned enterprises are not privatized, neither should they expect to be subsidized by the Government. These kinds of conflicting statements present a lack of discipline within the ranks at best, the notion that the audience is what determines the message at worst. It is possible that much of the internal bickering was being hashed out in the press and, with the release of the EPF, there may now be a clearer script from which GSL officials can read.

Comment

¶13. (C) Politics is the order of the day with the EPF (underscored in the minds of the UPFA by the similar recent electoral change in India), in deference to the rural voters who carried them to power. The EPF reads like a testimony of faith in the power of government, rather than markets, to lift the country out of its economic malaise. This possibly signals the influence the Marxist/Nationalist Janatha Vimukthi Peramuna (JVP) party on the UPFA coalition. Much of the plan, while highlighting a desire for competition or private-sector led growth, goes on to describe how the Government wants to engineer that competition or growth. While the agriculture and SME sectors are clearly in need of improvement, and were clearly at the root of the UPFA's electoral victory, the plan says little about key obstacles to development in these areas, such as land reform, a relatively shallow financial sector and inappropriate government interference in business and farming decisions (e.g. requirements for farmers to petition for permission to grow crops rather than rice in "designated paddy lands").

¶14. (C) Comment cont'd: Perhaps the EPF's biggest question-mark is its failure to address in a systematic way how the UPFA Government intends to finance new programs while trying to raise sufficient revenue to cut an already growing deficit. Based on Secretary Jayasundera's comments to the Ambassador about the work of the NCED and SEMA, it seems that the Finance Ministry is still focused on putting structure underneath the framework cover. In that regard, it will be necessary to watch the continued development of GSL discussions with the IFIs and the actions taken by the NCED and SEMA. (Note: The entire plan is available on the GSL Finance Ministry's website http://www.treasury.gov.lk/epsg/ecopolstgov.p df.) End Comment.

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